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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
	)	
Transport Rate Structure and Pricing Under Price Cap Regulation	)	CC Docket No. 91-213
	)	

JOINT COMMENTS OF BELL ATLANTIC AND NYNEX

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January 29, 1997

Summary

Access Reform -- the third-leg of the Commission's regulatory trilogy -- presents an opportunity for the Commission to use the market forces unleashed by the Telecommunications Act of 1996 (the "Act") to transform the access market. The Commission already has in place a price cap system that automatically reduces real access prices, while still providing regulated companies an opportunity to recover their costs and an incentive to be more efficient and make further investments. In the future, the local exchange carriers (LECs) will face increasing market pressure from competitors using unbundled network elements or reselling LEC services (as well as using their own facilities). The overall downward pressure on LEC rates that is produced by the price cap productivity factor will be supplemented by competitive pressures that will be concentrated by rate element, customer segment and geographic area. The Commission can help establish a competitive marketplace by giving LECs the flexibility to respond to these competitive challenges and to offer new services and pricing arrangements without regulatory constraint. At the same time, the Commission can use this proceeding to restructure access so as to ensure the opportunity for continued recovery of both traffic sensitive and non-traffic sensitive costs in a more economic manner and with minimal market distortions.

The Commission must reject the interexchange carriers' call to use regulatory mandates to prescribe lower rates. Such a prescription would destroy the incentive for future network investment. In particular, the Commission has no reason to adopt the self-serving position of the interexchange carriers, who are calling for prescription of access charges at levels far below what is needed to maintain a healthy network. The price cap system has proven to be a benefit to all

concerned -- it has capped and lowered prices to carriers and, although the long distance carriers have only partially passed along access rate reductions in their long distance rates, it has benefited consumers. It has also provided the LECs with the ability to recover their actual costs and the incentive to invest in a variety of new, more efficient technologies and services, and it has streamlined the regulatory process. These benefits would be lost if the Commission reverted to the discredited regulatory approach advocated by the long distance carriers, under which the Commission would prescribe confiscatory rate reductions. Only through an open market for access services, with pricing flexibility for all competitors, will the twin goals of robust competition and a continued healthy local network be achieved.

With respect to major issues raised in the Notice, Bell Atlantic and NYNEX agree that:

- The Commission should adopt a market-based approach to access charge reform;

- The Commission should eliminate price regulation and Part 69 rate structure requirements whenever a competitive alternative is available. Once a LEC has a state-approved interconnection agreement, the Commission should allow the pricing flexibility proposed in the Notice under Phase 1 and much of the pricing flexibility proposed under Phase 2;

- Until the Commission reviews its Separations policy and determines whether to change the current jurisdictional division of costs, LECs should be permitted to continue to recover interstate common line costs through the carrier common line charge and the subscriber line charge. The carrier common line recovery mechanism, however, should be changed from a per minute of use charge to a flat-rated charge based on presubscribed lines;

- The Commission should permit, but not require, the LECs to implement its proposal to raise the subscriber line charge for residence additional lines, including lines to second homes and for multi-line businesses, because it would be difficult to administer and would place the LECs at a competitive disadvantage. LECs should also be permitted, but not required, to deaverage subscriber line charges within the existing caps;

- The Commission should allow the LECs to create and adjust other rate elements to recover certain costs currently recovered through the Transport Interconnection Charge (TIC). Until the Commission reviews its separations policy, the remainder of the TIC should be billed to access customers on a flat-rated basis, such as a bulk-billed charge based on their interstate access minutes of use or a flat-rate transport charge based on presubscribed lines;

- The Commission should recognize the $4.5 billion regulatory underdepreciation of interstate investment by the industry ($740 million for Bell Atlantic and $158 million for NYNEX) and permit the LECs to recover it over a five year period;

- Terminating access is subject to competition and is not a bottleneck facility. If the Commission decides otherwise, any regulation of terminating access should be applied equally to all carriers; and

- The Commission should lower the current productivity offset for price cap regulation to reflect true measures of total factor productivity, as adjusted for the other changes made in this docket.

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JOINT COMMENTS OF BELL ATLANTIC[1] AND NYNEX[2]

As noted in the Commission's Notice of Proposed Rulemaking,[3] virtually all parties agree on the need for reform of the Commission's Part 69 access charge rules, which clearly do not allow efficient pricing of interstate access services.[4] While the existing access charge system, however inefficient, was feasible in a monopoly environment, the local exchange carriers ("LECs") cannot sustain it under the competitive conditions that will be produced by the

1 The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; and Bell Atlantic-West Virginia, Inc.

2 The NYNEX Telephone Companies ("NYNEX") are New York Telephone Company and New England Telephone and Telegraph Company.

3 ***Access Charge Reform***, CC Docket No. 92-262, Notice of Proposed Rulemaking, FCC 96-488 (rel. Dec. 24, 1996) ("Notice").

4 Notice, ¶ 41.

Telecommunications Act of 1996. New entrants can offer rates that are responsive to demand and consistent with the costs of serving each customer, and the availability of unbundled network elements from the LECs at cost will allow new entrants to avoid the uneconomic rates produced by the Commission's separations and Part 69 rules.

However, it would be unrealistic for the Commission to presume that, with proper study and analysis, it can devise an economically optimum level and structure for access charges that would replicate the rates that would be produced in a competitive market. Indeed, it is far more likely that a prescriptive approach would impede competition and prevent the market from producing efficient pricing. Government-dictated prices, however well-intentioned and carefully thought out, can only distort the market and harm both the LECs and the new entrants, and, ultimately, the consumer.

A market-based approach to access reform would result in the greatest public benefits and best carry out the goals of the Act "to provide for a pro-competitive, deregulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans."[5] Market-based prices would optimize use of the network, promote competition, encourage new investment by both incumbent LECs and new facilities-based competitors, and pass the benefits to the consumer in the form of lower rates and new, innovative services. The Commission should reject the self-interested arguments of the long distance carriers for prescriptive reductions in access charges that would stifle investment in the local network and prevent consumers from enjoying the benefits of competition.

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[5] S. Conf. Rep. No. 458, 104th Cong., 2d Sess., 113 (1996).

The Commission should deal with concerns about the overall level of access charges by continuing to rely upon the price cap system to encourage reasonable rates and increased LEC efficiency during the transition to a deregulated environment. There is no basis, either in fact or in law, for the Commission simply to dictate rate reductions based on economic theories or hypothetical costing models. It would be completely antithetical to the deregulatory purpose of the Act for the Commission to impose an array of new pricing controls and forced rate reductions.

I. The Commission Should Reform Access Charges in a Way That Continues the Benefits and Incentives of Price Cap Regulation. (¶¶ 1-49)

The Commission's decisions on access reform cannot be made in a historical vacuum. While no party would suggest that the Commission forfeit this opportunity for change, such change cannot ignore the policy and substance underlying the existing rates. The Commission's task is to ensure viable access competition, while at the same time upholding the social compact that the Commission made, on behalf of the public, with the LECs when it switched from cost-based regulation to price cap regulation. Price cap regulation has proven to be a benefit to all concerned -- it capped and lowered rates to carriers and, although the IXCs have failed to pass through the full benefit of these rate reductions, it has benefited consumers. It provided local carriers with the ability to recover their actual costs and the incentive to invest in a wide variety of new, more efficient technologies and services, and streamlined the regulatory process. As discussed below, the Commission should adopt a market-based approach to access reform that continues these benefits.

A. The Benefits of Price Cap Regulation (¶¶ 21-30)

Just twenty-one months ago, the Commission recognized the beneficial effects of price cap regulation. Begun at the start of this decade as a radical departure from the cost-based regulation of monopoly services, the vast majority of interstate access services are now under price cap regulation. Under the prior rate of return regime, companies had few incentives to make efficiency enhancing investments, because higher earnings from increased efficiency resulted in a reduction of rates.

In contrast, price caps created a new social contract between regulator and regulated.[6] Under price caps, LECs were encouraged to invest in new services, new and existing technologies, and new efficiencies. Companies under price caps that invested wisely and successfully were allowed to keep most of the resulting profits. As recognized by the Commission, price cap regulation "protects consumers by restricting the maximum prices that LECs may charge for interstate services."[7] At the same time, the Commission's price cap regulation "creates incentives for LECs to invest efficiently in new facilities and to offer innovative services that will lead to increased usage of the telephone network."[8] In sum, the Commission found that the current LEC price cap plan is "a program of improving consumer welfare by introducing profit incentives and

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[6] Affidavit of J. Gregory Sidak and Daniel F. Spulber, attached to USTA Comments, ¶¶ 14, 79-143 ("Sidak Affidavit").

[7] ***Price Cap Performance Review for Local Exchange Carriers***, 10 FCC Rcd 8961, 8965 (1995) ("Price Cap Review Order").

[8] ***Id.***

price constraints that more closely replicate the operation of competition than traditional rate-of-return regulation."[9]

The Commission was able to reach its endorsement on the basis not just of the theoretical soundness of this regulatory approach, but of the actual results. The Commission found that interstate access rates have declined "significantly under price cap regulation."[10] After four years, LEC customers had enjoyed a cumulative savings of almost six billion dollars.[11] At the same time, LECs increased their investment in new plant.[12] Furthermore, most states have followed the Commission's lead in moving to price cap regulation as a transition to competition.[13]

While the Commission left open the final determination of an appropriate productivity offset level in its most recent review of price caps, it firmly rejected any suggestion that it abandon price caps and return to cost-based rates.[14]

B. Additional Market Pressure on Access Prices (¶¶ 32-40)

What has changed since that order? Congress has passed its reform of telecommunications law. The Act opens LEC exchange and exchange access markets to competition, through

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9 *Id.* at 9002.

10 *Id.* at 8986.

11 *Id.* at 8987. By July 1996, that number had grown to $ 9 billion. Taking inflation into account during this same six year period, the real cumulative services which were passed on to the interexchange carriers was $19 billion. ***See*** USTA ex parte, CC Docket No. 94-1, LEC Price Cap Regulation (Apr. 2, 1996).

12 Price Cap Review Order at 8988.

13 According to NARUC, twenty-six states employ price caps. ***NARUC Report on the Status of Competition in Intrastate Telecommunications***, Table 13 at pp. 180-181 (August 1995 update).

14 ***See*** Price Cap Review Order at 8967, 8973.

competing facilities, resale of LEC services, and unbundled offerings of LEC network components. More customers will have a competitive alternative faster than might have occurred without the legislation. In addition, the Commission has ruled that purchasers of unbundled elements may use those elements to provide their customers with access services.[15] This means that LECs providing access must compete on price not only with alternative providers, but with providers utilizing the LECs' own unbundled facilities, which the competitor combines or rebundles to provide exchange and exchange access services.[16] The inevitable result will be to drive down the market price of access services.

The Act also allows the Regional Bell Operating Companies (RBOCs) to enter the long distance market upon meeting a comprehensive checklist that is designed to open local markets to competition. Once in the long distance market, the RBOCs' long distance affiliate must pay the same access charges as the LEC offers to nonaffiliated long distance carriers for comparable services. Because the RBOCs must compete with long distance carriers that are free to seek out the lowest priced access alternatives, access rates are under further market pressure.[17]

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[15] ***Implementation of the Local Competition Provisions in the Telecommunications Act of 1996***, 11 FCC Rcd 13042, 13049 (1996). While portions of the Commission's interconnection order are currently stayed by the 8th Circuit Court of Appeals, the use of unbundled elements to provide access is not a subject of appeal.

[16] Alternatives to RBOC switched access services include not only unbundled facilities and RBOC special access and dedicated facilities, but similar services from other providers, including competitive access providers, wireless broadband providers, and electric utilities' fiber backbones. Indeed, AT&T has recently announced its intention to bypass RBOC facilities and rely on alternative carriers and wireless (through Winstar's wireless loops). ***See*** S. Rosenbush, "AT&T Maps Shortcut to Providing Local Service," USA Today at 1B (Jan. 17, 1997).

[17] In addition, the Act mandates a new look at universal service support. The Joint Board has made its recommendations, and largely left to be resolved in this docket the issues of the carrier common line charge, the subscriber line charge and recovery of other costs assigned to the

None of these changes undercut the positive impacts of price cap regulation. Indeed, these changes suggest that market forces alone can act to push access prices lower. Additional price decreases are inevitable as the changes engendered by the Act take hold.

C. The Harm in Abandoning Price Caps (¶¶ 15, 30, 41-49)

At risk in this proceeding is the future of the beneficial balance brought about by price cap regulation. The essential balance of price caps is that it eases restrictions on profits at the same time that it challenges LECs to lower costs through the annually adjusted price cap. The result is that LECs "have the incentive to become more efficient and innovative at the same time that customers benefited from lower rates."[18] LECs continue to invest in greater efficiency and new services because of the promise of keeping the potential reward. In this way the incentives in price caps mirror a competitive market.

If the Commission were to use a regulatory cost measure to lower rates, which it should not, it would upset that delicate balance. Regardless of whether it were to rely on forward looking costs or actual historical costs to set rates, there could be no return to true price cap incentives. A LEC (and the investment community) would know that the regulatory promise of potential profits for new investment is a sham. The LECs would be taught by example that any real success will be rewarded by a change in the rules that takes away that potential profit. Once a regulator turned its back on the promises underlying price cap regulation, it could not go back. A rational regulated company would not make future investments where it would bear all of the risk of failure, while

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interstate jurisdiction. ***Federal-State Joint Board on Universal Service***, CC Docket No. 96-45, Recommended Decision, ¶¶ 753-754, 771-776 (rel. Nov. 8, 1996) ("Recommended Decision").

18 Price Cap Review Order at 9002.

any potential return would be confiscated by the regulator. This is especially true in an industry like telecommunications, where there are unregulated and foreign business opportunities competing for investment dollars. If the Commission takes away the "profit making incentives" of price caps, it must recognize that companies will no longer be encouraged to "reduce costs, invest efficiently in new plant and facilities and develop and deploy innovative services offerings."[19] In addition, investors will look to other companies for a higher return on their investment.

The only way the Commission can maintain the beneficial mix of continued network investment and reduced prices is to rely on a combination of market forces and price cap regulation. The Commission's market-based proposal contemplates such enlightened regulation.[20]

II. The Commission Should Adopt A Market-Based Approach to Access Reform. (¶¶ 5-7, 8-9, 14-15, 25-26, 35, 42-49, 98, 108-109, 112-122, 161-221)

A. Current Access Charge Rules Stand In The Way Of Efficient Pricing. (¶¶ 5-7, 9, 14, 25-26, 98, 108-109, 242-246)

There is no question that the existing access charges, which are the product of years of public policy decisions, are not directly linked to the economic cost of providing interstate access services. As the Commission notes, there is no basic difference between the carriage of traffic between an end user premises, on the one hand, and an interexchange carrier ("IXC") point of

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19 Notice, ¶ 30.

20 NYNEX and Bell Atlantic have already taken a number of interim steps toward access reform in response to competitive pressures in the access marketplace. Bell Atlantic has filed a petition to reclassify Bell Atlantic as a nondominant provider of interLATA corridor services, and NYNEX has implemented its Universal Service Preservation Plan in LATA 132, and filed for an extension of this waiver to Boston. The NYNEX Telephone Companies Petition for Waiver, filed Dec. 13, 1993; ***see also*** FCC Memorandum and Order, 10 FCC Rcd 7445 (1995). These actions are consistent with those proposed here.

presence ("POP") or another end user premises, on the other hand.[21] Traffic from an end user to either a POP or to another end user must pass through the end user's line port, must be routed by the switch, and must pass through interoffice facilities to reach its destination. Yet the rates for interstate access service are much higher than the rates for local calls.[22] The difference between these two rates is not inefficiency, nor is it excess profits. In both the intrastate and the interstate jurisdictions, rates are designed to recover the Part 32 accounting costs that are allocated to each jurisdiction. The high interstate rate is entirely a product of excess cost allocations to the interstate jurisdiction.

The Part 69 access rate structure rules compound this problem of over-allocation of costs to the interstate jurisdiction by recovering most costs on a usage basis. This causes customers who carry a large number of interstate calls to bear a much greater share of interstate cost recovery than customers who carry fewer interstate calls. In a competitive market, alternative providers that do not share the LECs' obligation to serve low volume customers can offer more attractive rates to high volume customers. This has already occurred for most large business customers, who have connected their PBX switches directly to IXCs, using the Special Access services of the LECs or of CLECs, in order to avoid more expensive switched access services.

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21 Notice, ¶¶ 9, 26. While IXCs employ more efficient dedicated transport facilities between an end office or a tandem office and a POP, the Commission isolated the rates for those services from usage-based switched access charges in the local transport restructure in CC Docket No. 91-213. The remaining usage-based switched access charges recover the costs of end office switching and common transport facilities that are used to provide local service as well.

22 This anomaly is the result of deliberate regulatory decisions over several decades. ***See*** Affidavit of James M. Fischer, Albert P. Halprin, Henry M. Rivera and Marvin R. Weatherly at 14-15, attached to USTA Comments ("Fischer Affidavit").

The Telecommunications Act of 1996 will accelerate bypass of the LECs' switched access services by making it easier for alternative providers to offer their own switched services.

The universal service fund does not address the revenue shortfall that results as high volume customers abandon the LECs' switched services. The universal service fund only recovers the costs of services that are defined as "universal service" under Section 254 -- service to high-cost areas, low income customers, schools, libraries, and rural health care providers.[23] The underrecovery of costs from low volume users must be addressed as part of access charge reform.

B. The Introduction Of Local Exchange Competition, Both Facilities-Based and Non-Facilities Based, Makes It Impossible For The LECs To Maintain The Current Level And Structure Of Interstate Access Charges. (¶¶ 8, 35, 48, 112-122)

Whether a new entrant uses its own facilities or purchases unbundled network elements from the LEC, it will be able to undercut the LEC's interstate switched access charges and make it impossible for the LEC to recover its remaining interstate costs. By allowing new entrants to purchase unbundled network elements at cost on a total company basis before separations, the Act allows competitors to avoid costs allocated to interstate access. With unbundled network elements, all minutes of use, both state and interstate, and both local and toll, will be priced the same. The offering of lower cost access services provided through unbundled elements side-by-side with the existing LEC access charge structure places the LECs at a competitive disadvantage under the current separations and access charge rules. The LECs will have to lower their access charges to compete in the market, or lose significant market share to competitors that are able to

[23] *See* 47 U.S.C. § 254.

realize a lower cost structure either due to construction of new state-of-the-art facilities, or due to the arbitrage made possible by regulatory rate prescription.

C. Cost-Based Pricing Of Access Services Does Not Replicate Pricing In A Competitive Market. (¶¶ 42-49, 219-221)

The IXCs have argued that access charges should be reduced because they exceed the forward-looking incremental costs of operating a new local exchange network with the most modern available technology.[24] They advocate a prescriptive approach, under which the Commission would force access charges to these levels, on the grounds that it would replicate the rate levels that would be produced by a fully competitive market for local exchange services.

As set forth below, such an approach is bad policy and would ignore LECs' legal right to have the opportunity to recover their costs. The Commission should also recognize that this approach would not replicate the rates that would be produced by a competitive market, and that it would actually prevent such competition from occurring.

One of the features of a competitive market is that providers offer a variety of rate levels and structures to meet demand in various market segments and to develop competitive advantages. Even if cost inputs are similar for all suppliers, prices are not necessarily set at those costs. Marketing strategies and supply and demand determine prices. Cost-based prices are not characteristic of a competitive market, except in the overall sense that a supplier's package of prices for all of its goods and services must cover its costs.

For example, cellular service providers almost uniformly provide a subsidy, in the form of a commission, to those who sign up customers for their cellular service. They offer

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24 Notice, ¶ 46.

commissions because customers have a strong resistance to high up-front costs of establishing cellular service. The carriers recover the subsidies by charging above-cost rates for cellular service. While this rate structure might not be considered cost-causative in a regulatory market, it is the product of a highly competitive market, and it is clearly economic because it maximizes demand for cellular service. Similarly, IXCs offer a variety of pricing plans for long distance service, including different combinations of flat fees, usage-based fees and volume discounts, even though their network costs of serving all customers are essentially the same. In both cases, the level and structure of prices are the result of marketing plans designed to secure a competitive advantage. The variety of different pricing plans, rather than standard "cost-based" pricing, is the best indication of a fully competitive market.

The Commission can no more predict the prices that would be produced by a competitive market than it could have predicted the types of prices that are being offered in the cellular or long distance markets. In fact, the Commission can be certain that if it had tried to dictate prices and rate structures in these markets, it would never have come up with some of the more innovative long distance company rate plans, such as MCI's Friends and Family, or the solution that the cellular carriers developed to offset the cost of cellular telephones. Any regulatory prescription is harmful because it impedes the ability of both new entrants and the LECs to introduce innovative pricing plans to meet consumers' needs.

D. A Market-Based Approach Will Produce The Greatest Consumer Benefits. (¶¶ 14-15, 47, 161-217)

The best way -- in fact the only way -- to encourage economically efficient pricing of access services is to rely upon a market-based approach. The Telecommunications Act of 1996 provides a variety of ways for new entrants to provide local service, including resale of incumbent LEC services, use of the LECs' unbundled network elements, and provision of their own facilities. Many new entrants will use all three approaches, depending on which method is the most efficient means of serving a particular customer or class of customers. Their rates, including their access rates, are likely to reflect the costs that they incur and the best way of recovering those costs from each group of customers. In this situation, a LEC will face pricing pressures if its rates for any services, including access services, are higher than the rates that new entrants will charge. Therefore, the Commission should provide reduced levels of pricing regulation as barriers to entry are removed and competition emerges.

The market-based approach outlined in the Notice, with the modifications discussed below, is the best way to achieve the benefits of a competitive market. Price cap regulation was meant to be a substitute for competition. As competition develops, price cap regulation must be removed because the two cannot effectively and efficiently co-exist.

The IXCs, who favor a prescriptive approach, argue that the Commission needs to force the LECs' access rates to the level of forward-looking costs, because the LEC long distance affiliates will have an unfair competitive advantage.[25] This is based on the theory that the "real" cost to the LEC of providing interstate access service is the incremental cost, and that even the rule requiring the LEC to charge its long distance affiliate the same access charges that it applies to non-affiliated long distance carriers is not economically meaningful.[26] According to the IXCs,

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[25] Notice, ¶ 47.

[26] In fact, LECs must charge their affiliates *switched* access rates which can result in higher costs than the special access rates that non-affiliates may purchase,.

the LEC long distance affiliate could engage in a "price squeeze" by lowering its rates for long distance service by the amount of the difference between incremental costs and existing access charges.

This ignores reality. The LEC must recover its costs of long distance service in addition to its interstate access services to make it economically attractive to be in the long distance business.[27] Put another way, even if the Commission did not require the LECs to impute access charges to their long distance affiliates, the LEC would have no financial incentive to enter the long distance market unless the additional revenues from that business covered the costs of providing long distance service in addition to the opportunity costs of foregoing access charges that would otherwise be paid by non-affiliated long distance carriers.

As financial analysts Anna-Maria Kovacs and Kristen Burns recently explained:

> We find the "price squeeze" argument somewhat puzzling, even if we disregard the legal requirement that the LECs charge their own long distance subsidiaries the same access as they do their competitors. . . . [A] LEC that takes away a minute of traffic from an IXC and turns around and charges less than full access on that minute from the end-user, loses real revenue and margin. It is certainly possible that LECs might choose to give up margin to underprice IXCs, but they could do that under any circumstances. If LECs operate on the idea the real cost of access is a hard cost they cannot ignore, and the opportunity cost of lost access margin is a soft cost that they can use to underprice, then their consolidated financials will suffer.[28]

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27 Indeed, financial analyst Jack Grubman of Salomon Brothers examined GTE's experience and identified new incremental marketing and customer service costs that result in losses and "upward pressure" to GTE's cost structure. Mr. Grubman predicts similar impacts to the RBOCs as they enter the long distance market. First Call (Jan. 27, 1997).

28 Janney Montgomery Scott Industry Update, "Notice of Proposed Rulemaking: Access Charge Reform" at 8 (Jan. 2, 1997).

In other words, the "LEC price squeeze" is a myth.[29] Indeed, it is the incumbent long distance carriers that have the ability to squeeze the LECs. The incumbent interexchange carriers may obtain unbundled local and access services at below-cost prices and resale services at deep discounts, yet they have no obligation to give LECs similar treatment as they enter the long distance market.

The Commission recently recognized that the availability of unbundled network elements at cost will enable the long distance carriers to avoid any price squeeze by the LEC.[30] If a LEC charged an uneconomically high price for access services, an IXC could simply purchase unbundled network elements at cost and have the same cost "advantage" as the LEC. The classic price squeeze theory assumes that one company has control over a cost input that competing providers cannot avoid. Here, all IXCs can avoid paying access charges. Access service provided by a LEC is no longer an essential input to the provision of long distance services. Regardless of a LEC's market share at any given moment, it will be subject to the discipline of a competitive market if it tries to recover more than its costs of serving a particular customer, as measured by the rates for unbundled elements. For this reason, the market-based approach cannot give the LEC a competitive advantage in the market for long distance services.

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29 ***See also*** R. Schmalensee and W. Taylor, "Economic Aspects of Access Reform," NERA, at 43-45 ("Economic Aspects"), attached to USTA Comments (Commission should not be concerned about LEC price squeeze because of increasing access competition, existing regulatory safeguards, and state regulation of local prices).

30 ***Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, As Amended,*** CC Docket No. 96-149, First Report and Order and Further Notice of Proposed Rulemaking, FCC 96-489, ¶ 258 (rel. Dec. 24, 1996).

III. The Commission Must Provide an Opportunity for LECs to Recover Their Actual Costs. (¶¶ 14, 190-230, 247-270)

Whether or not the Commission continues the incentives of price cap regulation, it cannot require that switched access services be priced based on some measure of future or theoretical costs. Price cap regulation is an extension of an enduring compact with the regulator that the regulated company will have an opportunity to recover its actual costs. The initial rates going into price cap regulation were cost-based rates found just and reasonable by the Commission through rate of return prescriptions and comprehensive annual tariff review proceedings.[31] Under price cap regulation, those cost-based rates fluctuate largely independently of cost changes, because the price cap system provides the regulated company an opportunity to recover actual costs by allowing it to invest in its own productivity, thereby reducing costs sufficiently to cover the real price reductions mandated by the price cap formula. Were the Commission to abandon price cap regulation, it would have to put in place a new mechanism to recover actual costs.[32] Moreover, it would be an unconstitutional taking for the Commission to adopt its prescriptive approach and reinitialize rates to match Total Service Long Run Incremental Cost

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31 ***Policy and Rules Concerning Rates for Dominant Carriers***, 5 FCC Rcd 6786, 6946 (1990) ("LEC Price Cap Order").

32 Even if the Commission were to retain the shell of price cap regulation, but were to require price reductions unrelated to anticipated productivity (either through a larger offset or a "one-time" adjustment), the Commission would have to ensure that the new price levels offered LECs the opportunity to recover their actual costs. Affidavit of Dr. Robert W. Crandall at ¶ 13 ("Crandall Affidavit") attached as Exhibit 1.

("TSLRIC") or Total Element Long Run Incremental Cost ("TELRIC"). This is not only a requirement of good public policy; it is a constitutional mandate.[33]

A. Prescription Based Only On Forward Looking Rates Would Be Unlawful. (¶¶ 218-227, 247-270)

The Commission requests comments on whether it should prescribe a reduction in LEC access charges based on calculations of TSLRIC.[34] The proponents of such a prescriptive approach advocate using proxy-type models that calculate incremental cost for a "most efficient provider," using the latest technology rather than the existing LEC network. However, regardless of whether proxy or incremental costs are used in a hypothetical, forward-looking calculation, the Commission cannot base rates on such costs unless the end result provides the LECs with "just compensation" for use of their existing, prudently made investment. It is long standing law that the Fifth Amendment requires that a utility be permitted to charge a price that will allow it to "maintain its financial integrity, to attract capital, and to compensate its investors for the risk [they have] assumed."[35] Thus, to meet the constitutional floor, "rates must provide not only for a company's costs, but also for a fair return on investment."[36] Before a return on investment can be contemplated, the company's "costs" must be recovered. These costs cannot be based on someone else's costs, or on a hypothetical network as contemplated under TELRIC.

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33 *See* Sidak Affidavit.

34 Notice, ¶ 223. The Commission also seeks comment on whether such TELRIC calculations should be based in part on the TELRIC of certain unbundled network elements. Id., ¶ 225.

35 ***Duquesne Light Co. v. Barasch,*** 488 U.S. 299, 310 (1989) (***quoting Fed. Power Comm'n v. Hope Natural Gas Co.***, 320 U.S. 591, 605 (1944)).

36 ***Tenoco Oil Co. v. Dept. of Consumer Affairs***, 876 F.2d 1013, 1020 (1st Cir. 1989).

They must be the company's actual costs. Moreover, they cannot ignore past investment as contemplated under either TELRIC or a pure TSLRIC standard.

Other regulatory bodies have recognized that changes in technology or competitive conditions cannot form a basis for a regulator to ignore the actual costs incurred by a regulated company. For example, the Federal Energy Regulatory Commission ("FERC") recently confronted the issue of cost recovery for embedded costs in the electric utility industry. FERC recognized that changes in technology and "the transition to a fully competitive bulk power" could create a situation where legitimate past investment would be "stranded" and could not be recovered based on forward looking rates.[37] Like the Commission, FERC's goals included an effort to "ensure that customers have the benefits of competitively priced" services.[38] But FERC also reaffirmed its commitment to meet that goal "without abandoning [its] traditional obligation to ensure that utilities have a fair opportunity to recover prudently incurred costs."[39] As a result, FERC put in place a pricing mechanism that would give electric utilities the opportunity to recover "stranded" investment.[40] Similarly, the Commission must recognize LECs' legitimately incurred costs, and give LECs the same opportunity.

The only currently available measure of actual costs of interstate services are those costs calculated under the Commission's own rules. Only through Part 36 separations is there any

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37 ***Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities***, Order No. 888, 1996 WL 355535, *17 (F.E.R.C.) (Apr. 24, 1996).

38 ***Id.*** at *19.

39 ***Id.***

40 ***Id.*** at *17.

identification of the interstate portion of regulated costs. The Commission itself has recently recognized that Part 36 cost recovery is the appropriate floor to test constitutional takings claims. In its recent decision on 800 data base tariffs, the Commission addressed whether its denial of certain cost recovery was an unconstitutional taking. In concluding that there was no unlawful taking, the Commission relied on its analysis that the rates imposed by the Commission still gave the LECs an opportunity to recover their actual interstate costs as defined through Part 36 separations.[41] By the Commission's own logic, were access charges reduced to a level that did not permit recovery of their interstate costs as defined under Part 36, that would constitute a taking in violation of the Fifth Amendment.

The Commission must meet the same standard here. The Commission must allow prices to be set such that all costs allocated to the interstate jurisdiction have the opportunity to be recovered through interstate rates. Any cost standard that ignores these costs and only allows recovery of a lesser amount based on a different standard cannot withstand constitutional scrutiny.[42]

As a practical matter, it would be virtually impossible for LECs to achieve an actual cost structure that approaches a forward-looking TELRIC cost. LECs continually upgrade the network using the best available technology, as appropriate. These upgrades, however, must be integrated with existing architecture and embedded facilities, because it would not be prudent or economically feasible continually to replace all existing, but still useful, facilities simultaneously

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[41] ***800 Data Base Access Tariffs and the 800 Service Management System Tariff***, CC Docket No. 93-129, Report and Order, ¶ 83 (rel. Oct. 28, 1996).

[42] ***See supra.*** at 8-9.